No. 15072

IN THE

United States Court of Appeals For the Ninth Circuit

PEGGY LOU RIKER and FREDA H. GRASSMEE, *Petitioners*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*

On Petition for Review of the Decision of the Tax Court of the United States

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BRIEF FOR THE RESPONDENT

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BRIEF FOR THE RESPONDENT

OPINION BELOW

The memorandum findings of fact and opinion of the Tax Court (R. 80-96) are not officially reported.

JURISDICTION

The petition for review (R. 98-100) involves deficiencies in income taxes for the taxable years 1948 and 1949 in the amounts of $84.80 and $25.50, respectively, determined to be due and owing by taxpayer Grassmee; and in the amount of $1,404.68 for the taxable year 1948 determined to be due and owing by

taxpayer Riker. Deficiency notices were sent to taxpayers on November 25, 1952. (R. 9, 12, 13, 76.) Taxpayers filed petitions for redetermination with the Tax Court on February 19, 1953 (R. 3, 6), under the provisions of Section 272 of the Internal Revenue Code of 1939. The decisions of the Tax Court were entered on December 15, 1955, and served on December 16, 1955. (R. 96-98.) These consolidated cases are brought to this Court by a petition for review filed January 16, 1956. (R. 98-100.) The jurisdiction of this Court is invoked under the provisions of Section 7482 of the Internal Revenue Code of 1954.

QUESTIONS PRESENTED

1. Whether income derived from the operation of a restaurant by taxpayer Peggy Lou Riker was income taxable to her or to a religious organization of which she was a member.

2. Whether Christ's Church of The Golden Rule, which was authorized to and did conduct business for profit through its principal temporal agency, the Elected Delegates Committee, was a corporation "organized and operated exclusively for religious * * * purposes, * * * no part of the net earnings of which inures to the benefit of any private shareholder or individual" within the meaning of Section 23(o)(2) of the Internal Revenue Code of 1939 so that contributions or gifts thereto were deductible for income tax purposes.

3. Whether taxpayer Grassmee was entitled to dependency credits for her mother in the taxable years

1948 and 1949 under Section 25 (b)(1)(D) and (3) of the Internal Revenue Code of 1939.

STATUTE AND REGULATIONS INVOLVED

These are set forth in the Appendix, *infra*.

STATEMENT

The findings of the Tax Court (R. 81-88) may be stated as follows:

During the taxable years 1948 and 1949, taxpayers, Peggy Lou Riker and Freda H. Grassmee, were members of Christ's Church of The Golden Rule (hereinafter referred to as the Church), a religious nonprofit California corporation, which was organized in 1944. (R. 81, 84, 87.) The Church was adjudicated a bankrupt in 1945 and during 1948 and 1949 was in bankruptcy. (R. 81.)

The Church adopted a constitution (R. 20-30) and canon laws (R. 30-67) in 1948. According to its constitution (R. 22, 81-82), the economy of the Church is based upon a belief that economic equality is the only enduring foundation upon which to build industrial, business, political, national, and international relations; and that to insure such equality (R. 22)—

> the property and earnings of the individual members of the Church should be owned and managed by the Church for the benefit of all mankind in accordance with the rules and regulations of the ecclesiastical society of this Church, that God may be glorified and all mankind directly or indirectly benefited.

The ecclesiastical affairs of the Church are in the hands of an organization consisting of a Senior Elder, an Advisory Board of Elders, and College of Pastors. (R. 23-26, 82.)

The temporal affairs of the Church are in the hands of "temporal agencies," subject to the ultimate control of the ecclesiastical authorities. Such affairs are carried on through charters granted by the Senior Elder, with the advice of the Advisory Board, "to the various congregations, projects and other temporal activities." (R. 26-27, 82.)

According to the canon laws of the Church, a charter could be granted, withheld, or revoked upon whatever terms and conditions the Church government designated. Those laws provided (R. 33, 38, 82), *inter alia,* that all temporal agencies "shall hold their property upon a private trust for the ecclesiastical organization," and that (R. 38)—

> All transfers, conveyances and sales shall be presumed to be bona fide gifts to the Lord's work unless there be conditions or understandings or promises to the contrary in writing duly approved in writing by the duly constituted ecclesiastical Church Government.

In operation, activities of Church members are of two types. Some members devote all of their time to working in Church projects and studying to be ministers of the Church's teachings. These are called student ministers, and they live in apostolic societies called "Student Minister Training Projects." One purpose of these projects, most of which were engaged

in commercial activities, is to spread the teachings of the Church by having the public witness the application of these teachings in everyday life. Some projects were not engaged in commercial activities but simply operated residential facilities for Church members. Members living in both types of projects contributed their earnings to the Church. Other Church members lived at home and participated in Church activities. The Church operated a theological seminary. (R. 48, 82-83.)

The principal temporal agency of the Church is the Elected Delegates Committee (hereafter called the Committee) which was formed in 1946. (R. 83.)

During 1948 and 1949 the Committee operated various student minister training projects. It also operated the Church treasury and carried on various commercial activities in competition with privately owned enterprises, including, among others, a restaurant, a laundry, a lumber yard, bulb gardens, farming, stock raising, and a warehouse. These enterprises were operated for profit. Gross receipts from the operation of these projects were sent to the Committee, covered by a form stating that the transfer was an outright gift from the project manager and was to be used only for Church purposes. (R. 83.)

For 1948 and 1949 the Committee filed amended returns of income on Treasury Department Form 990 as an organization exempt under Section 101 of the Internal Revenue Code of 1939, and also amended returns as an apostolic society on the partnership Form 1065. The returns showed the Committee's gross income for 1948 as $484,981.44, of which $347,489.99

was reported as received from the operation of student minister training projects, and $137,491.45 from contributions and gifts. In 1949, gross income of $409,590.05 was reported, of which $352,528.70 was from the operation of student minister training projects, and $56,033.27 was from gifts and contributions. On the Committee's returns as an apostolic society, the undistributed pro rata share of each member of the apostolic society was reported as $342.27 for 1948 and $316.17 for 1949. (R. 83-84.)

Prior to joining the Church, Peggy Lou and her husband had operated a drug store in partnership with his parents. The partnership was dissolved and Peggy Lou and her husband took the fixtures of the business and made a cash settlement with his parents. The fixtures were then used to set up a student minister training project to operate a restaurant under the name of "Your Food Fountain" (hereafter sometimes called the Fountain). Peggy Lou was manager of the project and the business license was in her name. Her duties included giving religious instruction to "members" of the project, who varied in number from 12 to 17. All of the receipts from the operation of the Fountain were turned over to the Committee on a form such as that described above, signed by Peggy Lou as project manager. Funds were in turn allocated by the Committee from the Church treasury for the operation of the Fountain and the living expenses of the members of the group. (R. 84-85.)

While the bankruptcy proceedings of the Church were pending, Peggy Lou sued the trustees in bankruptcy to establish her ownership of the equipment

of the Fountain. An agreement (Pet. Ex. 9) was made in May 1947, between Peggy Lou and the trustees relating to the Fountain while the litigation was pending, which provided that Peggy Lou was to operate the establishment until the lawsuit involving ownership was settled. The income during this period was to belong to Peggy Lou and she was to pay the trustees certain amounts to be deposited by the trustees in a trust fund account. All operating expenses were to be paid by Peggy Lou. (R. 85.)

From May 1947 until July 1948, the restaurant was operated under this agreement. Of this period, from May 1947 until January 1948, the restaurant was run as a "Church project," and the earnings were turned over to the Committee by Peggy Lou. From January 1948 until June 1948, Peggy Lou ran the business in private partnership with other persons who were not members of the Church, and from June until September 1948, she operated the business on a percentage basis with a prospective purchaser of the business. Her partnership share of the restaurant's earnings was contributed to the Committee. For five months of her fiscal year 1948, January 20 to June 30, Peggy Lou filed partnership returns for three different partnerships that operated the restaurant in this period. In July 1948, the assets of the restaurant were sold to the Committee for $1,500. Peggy Lou consented to the sale. (R. 85-86.)

Peggy Lou filed an income tax return for her fiscal year 1948 (October 1, 1947, until September 30, 1948), which disclosed a net profit of $7,568.25 from the operation of a restaurant business under the name of

"Your Food Fountain." (R. 86.) A memorandum attached to the return reads as follows (R. 86-87):

ITEM 2. WAGES, ETC.

Taxpayer was employed by Own Business for a gross income of $8959.11 during the taxable year. However, under the rules of the apostolic society (of which taxpayer is an associate) that all in the society share their income, $8959.11 was contributed to and became a part of the income of the apostolic society, and is reported as part thereof. Taxpayer would therefore, be taxed twice on the same income by reporting it as wages and also as a dividend. For this reason, this latter sum is reported only as part of the dividend or taxpayer's pro rata share of the net income of said apostolic religious society. (See Item #3 Dividends).

ITEM 3. DIVIDENDS

1/575 interest in $217,001.54 net income of The Elected Delegates' Committee of The Ecclesiastical Society of CHRIST'S CHURCH OF THE GOLDEN RULE, an Apostolic Religious Association, for its accounting period of Oct. 1, 1947 to Oct. 1, 1948. This was not received as a dividend, but is reported under Sec. 101(18)—Per person in Association $377.39

Number of persons in taxpayer's family who were in association and obtained support from Society during period:

2 times $377.39 ..... $754.78

In her return for 1948, Peggy Lou claimed the sum of $8,959.11 as a deductible contribution to the Church.

This claim was disallowed by the Commissioner and this Action was alleged as error in the original petition. In an amended petition, it was prayed that the income of the Fountain be found to be the income of the Church. (R. 87.)

Freda H. Grassmee was employed in a law office in Los Angeles during 1948 and 1949, and contributed practically all of her salary for those years to the Committee. She and her mother lived in a Church residential project and participated in religious activities of the Church. Both received their support from the Church. Freda's income tax returns for 1948 and 1949 contained memoranda as to the disposition of her income similar to that attached to Peggy Lou's return. On her returns for both years, she claimed a dependency exemption for her mother. (R. 87.)

The Commissioner disallowed the deductions claimed as contributions to the Church in 1948 and 1949. In an amended answer, he claimed increased deficiencies based on disallowance of the dependency credits claimed for Freda's mother. (R. 88.)

The Tax Court sustained the Commissioner's determinations and held (1) that the income derived from the operation of the Fountain by Peggy Lou was her income and not that of the Church organization to which she contributed it (R. 88-89); (2) that no part of the amounts contributed to the Church by the taxpayers was deductible as a contribution to a religious organization since the Church was not organized and operated exclusively for religious purposes within the meaning of Section 23(o) of the Internal Revenue Code of 1939 (R. 91-95); and (3) that taxpayer Freda

H. Grassmee was not entitled to a dependency exemption for her mother since her support was received from the Church. (R. 96.)

SUMMARY OF ARGUMENT

Taxpayers were members of a church group, which, insofar as the record discloses, had no church buildings and engaged in no activities of a purely spiritual nature, as commonly understood. It did, however, engage in various commercial enterprises under the title of "Student Minister Training Projects." In addition to the production of income, the purpose of these projects was alleged to be to permit the public to witness the application of the Church's precepts to everyday life. Just how these precepts were applied or how the conduct of these business enterprises differed from an admitted commercial activity is not explained or discernible.

During the taxable period, taxpayer Riker operated a restaurant and taxpayer Grassmee was employed in a law office. Both lived in Church housing projects, contributed their earnings to the Church, and then received a so-called dividend or pro rata share of the net income of the Church, or more specifically of the Committee, the principal temporal agency of the Church. Both claimed that their contributions were deductible in part under Section 23(o)(2) of the Internal Revenue Code of 1939. In addition, taxpayer Riker contended alternatively that she operated the restaurant as a Church project and, hence, that the income from its operation belonged to the Church and not to her.

During the taxable period, the Church was in bankruptcy. According to the Tax Court's findings, taxpayer Riker operated the restaurant during this period in part as a Church project under an agreement with the trustees in bankruptcy whereby the income therefrom belonged to her, and in part as a private business enterprise. It concluded, therefore, that the restaurant income belonged to taxpayer Riker, rather than to the Committee, and was taxable to her, as the one who had earned it. We submit, however, that the evidence fails to support the finding that the restaurant was ever operated as a Church project or that it was an asset of the bankrupt estate, and hence that under no circumstances can it be said that any part of the income from its operation belonged to the Church or the Committee rather than taxpayer Riker. Neither does the evidence support the contention, nor do taxpayers demonstrate, that the Committee, or the entire Church organization, qualifies as a religious or apostolic association or corporation under Code Section 101(18), so as to constitute the income, from the various commercial activities, income of the Committee, rather than of the members of the Church.

It is also clear that neither the Church, i.e., the "ecclesiastical society," nor the Committee, its principal temporal agency, qualified as an organization "organized and operated exclusively for * * * religious * * * purposes" within the meaning of either Section 23(o)(2) or 101(6) of the Code. In fact, the evidence does not warrant any distinction between these two facets of the Church's operations, for both were under the complete domination and control of the Senior

Elder. The Committee was merely an agency of the ecclesiastical society of the Church for carrying out its temporal functions, and hence its commercial activities must be ascribed to the latter, or more properly to the Church itself. Even if such a distinction be assumed and the ecclesiastical society be accepted as a qualified religious organization within the meaning of Sections 23(o)(2) and 101(6), it is clear that the Committee did not so qualify, and that under decisions of this Court the so-called "ultimate distinction" test cannot be applied by analogy so as to render contributions to the Committee for the use of the ecclesiastical society of the Church deductible for tax purposes.

Taxpayer Grassmee has also failed to sustain her burden of proof in support of her claim that she was entitled to a dependency credit for her mother.

ARGUMENT

I

THE INCOME FROM THE OPERATION OF THE RESTAURANT WAS TAXABLE TO TAXPAYER PEGGY LOU RIKER

A. Preliminary

In her original petition to the Tax Court (R. 13-16), taxpayer Peggy Lou Riker alleged that her income from all sources for the year ending September 30, 1948, was $8,595.11, that she made a gift thereof during that taxable period to Christ's Church of The Golden Rule, an alleged tax exempt organization under Section 101(6) of the Internal Revenue Code of 1939, Appendix, *infra,* and prayed, *inter alia,*[1] that

[1] She also prayed that certain property and sales taxes in the amount of $168.61 be allowed as proper deductions, and that the Tax Court determine her income to be $8,959.11, rather than

"the donations to said Church be properly allowed as deductions for religious purposes" (R. 16). In an amended petition (R. 68-74), she alleged that her income from all sources for the period in question "was the sum of $377.39 per person, herself, and her minor child residing with her, being an undivided 1/575 interest in the net income of the Apostolic Society" (R. 68); that she reported such income as $754.78; and that "said income is a proportionate share of the gross receipts, including gifts, to the Common Community Treasury of the Apostolic Society of Christ's Church of the Golden Rule" (R. 68-69). Whereupon, she prayed further that the Tax Court determine that "the funds of Your Food Fountain are properly income of the said committee of said Church, and that your taxpayer is taxable under the provision of Subdivision 18, Section 101 of the Revenue Code, only for her proportionate share, whether received or not, for herself and her minor child, after deduction of personal exemptions of the taxpayer and her minor child therefrom." (R. 74.) In his answer, the Commissioner denied these allegations. (R. 76-77.)

The pleadings thus raise three issues: (1) Whether the income from the operation of the restaurant, Your Food Fountain, was that of taxpayer Riker or the Church of which she was a member; (2) if the income of the taxpayer, whether the Church qualified as a religious organization under Section 23(o)(2) of the Internal Revenue Code of 1939, Appendix, *infra,* so as

$9,713.89, as corrected by the Commissioner. In his deficiency notice, the Commissioner stated that, inasmuch as the standard deduction had been claimed, the deduction claimed for taxes had been included in computing her adjusted gross income. (R. 16, 19.)

to entitle taxpayer to a 15 per cent deduction with respect to the contributions she made to it during the taxable year 1948; and, alternatively, (3) whether the Church qualified as a religious or apostolic association or corporation under Section 101(18) of the Internal Revenue Code of 1939, Appendix, *infra,* so that taxpayer, as a member thereof, was taxable only on her pro rata share of the net income of such association or corporation.

B. The Income From the Operation of Your Food Fountain Was That of Taxpayer Riker and Not That of Either the Church or Its Principal Temporal Agency, the Committee

In holding that the income from the operation of the Fountain during the taxable period October 1, 1947, to September 30, 1948, belonged to taxpayer, the Tax Court recognized (R. 89) three distinct phases of operation during that period: (1) October 1947 to January 1948, when she ran the restaurant "as a Church project"; (2) January to June 1948, when the restaurant was run as a private business (not as a Church project) by a partnership of which she was a member; and (3) July to September, 1948, when she operated the business on a "percentage basis" with another person who was interested in buying the property.

With respect to the first two phases, the Tax Court held (R. 89-90), that, "at least" during that period (October 1, 1947, to June 30, 1948), Peggy Lou operated the restaurant under an agreement with the trustee in bankruptcy; that according to the agreement she had an unqualified right to receive the funds from its operation; that her testimony was that she did receive the funds; and, therefore, that the income

she received from its operation was hers "and not the Committee's."

It is a fundamental assumption of the Tax Court's decision that the restaurant business known as Your Food Fountain was an asset of the bankrupt Church. Section 70 of the Bankruptcy Act, c. 541, 30 Stat. 544 (11 U.S.C. 1952 ed., Sec. 110), vests the trustee, by operation of law, only with such title as the bankrupt organization had prior to its adjudication. *Zartman* v. *First National Bank,* 216 U.S. 134; *Schultz* v. *England,* 106 F. 2d 764 (C.A. 9th); *In re Pagliaro,* 99 F. Supp. 548 (N.D. Cal.), affirmed *per curiam, sub nom. Costello* v. *Golden,* 196 F. 2d 1017 (C.A. 9th). Property to which the bankrupt has no ownership right does not become a part of the bankrupt's estate. *In re Goldsby,* 51 F. Supp. 849 (S.D. Fla.). If, therefore, the Church had no title to the business or right to the income therefrom at the time (1945) of its adjudication as a bankrupt, the entire income belonged to Peggy Lou, as the owner and operator of the business, and was taxable to her; and the trustee had no right to enter into the above-mentioned agreement which formed the basis of the Tax Court's decision. Insofar as disclosed by the record, the facts are as follows:

The Church, as found by the Tax Court, was adjudicated a bankrupt in 1945 and continued in a status of bankruptcy during 1948 and 1949. (R. 81.) During the pendency of those proceedings, according to the Tax Court's finding (R. 85), Peggy Lou sued the trustees in bankruptcy to establish her ownership of the "equipment" of the Fountain.

Although the Tax Court visualized that suit as one to determine ownership of the restaurant "equipment" and as bearing on the right to the income in question (R. 85, 88, 90), we think it was in error in so doing, for we submit that ownership of the "equipment" as opposed to ownership of the business could not serve as a basis for determining the right to the income from the operation of the business. Petitioners' Exhibit 9, which is the only evidence of record concerning the nature of Peggy Lou's suit against the trustees, consists of (1) a copy of a "Petition for Authority to Execute Operation Agreement Re Your Food Fountain and for Approval of Said Agreement" to which is attached a copy of the agreement in letter form, and (2) a copy of an order signed by the Referee in Bankruptcy authorizing execution of the agreement. The petition recites that "litigation is now pending for the determination of the ownership of Your Food Fountain," and that "to the end that provisions may be made for the operation of said cafe in order that its good will may be preserved during the pendency of the said litigation," the trustees and Peggy Lou had negotiated the proposed agreement. The order authorizing the execution of the agreement described it as providing "for the operation of the business known as Your Food Fountain * * * during the pendency of the litigation now pending to determine the ownership thereof." It appears, then, that the nature of Peggy Lou's suit was one to determine the ownership of the business rather than merely of the "equipment" used therein.

Other facts of record tend to indicate that Peggy Lou rather than the Church did own the business, as well as the equipment and property. Thus, according to her testimony (R. 115-116, 144), she and her husband purchased property at San Bernardino, California, and with "fixtures" acquired from a former business established Your Food Fountain as a student minister training project. The business license, moreover, was carried in Peggy Lou's name as an individual. (R. 145.)

There is no evidence of record that prior to the bankruptcy proceedings Peggy Lou ever transferred or conveyed either title to the business or its assets to the Church. Neither is there any evidence that Peggy Lou, as an individual, or the group or project of which she was leader, was ever chartered as a "temporal agency"[2] of the Church so that it could be said that under the constitution and canon laws of the Church (R. 27-28, 33) the restaurant or its assets were held "in trust for the benefit of the ecclesiastical society of this Church."[3]

Other than the irrelevant fact that the physical assets of the restaurant business were sold with the

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[2] A "temporal agency" is defined in the canon laws as (R. 34-35) —any person, natural or artificial, or group or entity who acts in any way in matters temporal or secular for the ecclesiastical Church Government or religious society or any part thereof or any project, congregation or activity of the Church or who holds any property subject to any religious trust or use or purpose under the doctrines, teachings or beliefs of the religious society or ecclesiastical Church Government.

[3] It is noted that whereas the Constitution speaks of a temporal agency holding in trust "property of the Church" to which it has title or possession (R. 27-28), the canon laws provide that such agencies shall hold in trust "their property" (R. 33).

approval of Peggy Lou to the Committee (the principal temporal agency of the Church (R. 83)) in July 1948, and the further fact that the proceeds from the "sale of the restaurant" in late 1948 or early 1949 went to the Committee and not to Peggy Lou (R. 86, 90), the record discloses no determination as to ownership of the restaurant business. In the absence of any such determination and under the facts of record, it does not appear that the business was an asset of the estate of the bankrupt Church which the trustees had any right to deal with, and hence to declare that Peggy Lou should operate the business and be entitled to the income from its operation. The fact of the matter appears to be that Peggy Lou, and not the Church or the trustees in bankruptcy, owned the business and was entitled to the income therefrom in her own right.

Even assuming that the trustees rightfully dealt with the restaurant as an asset of the bankrupt estate, the income in question belonged, as the Tax Court held, to Peggy Lou and not to the Church. Under the terms of the agreement, executed in May 1947, Peggy Lou was to operate the restaurant until the question of ownership was settled. The agreement provided that "All funds derived from the operation of the cafe under this arrangement shall belong to you"; that she was to pay all operating expenses, as well as the payments "covering the incumbrance now on the real property known as Green Acres Ranch"; and that she was to pay specified sums to the trustees monthly to be deposited in a trust fund account, which payments were (1) to cover depreciation of

assets of the business while in her possession, and (2) to constitute payment by her in purchase of the inventory value of food and supplies of the value of $483.04. It was further provided that, in the event that it was finally adjudicated that Peggy Lou had no interest in either the realty or personality of the business, the money paid into the trust fund account was to pass absolutely to the trustees as a part of the bankrupt estate, but that otherwise, it was to be disposed of in accordance with the decision "as to the ownership of the business." (R. 85, 89; Pet. Ex. 9.)

On the basis of its findings (R. 85), the Tax Court held (R. 88-89), that Peggy Lou operated the restaurant under the agreement until July 1948, when the restaurant "equipment" was sold to the Committee.[4] It further held (R. 85, 89) that "According to her testimony," she, as the project manager, ran the restaurant "as a Church project"[5] during that

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[4] On July 22, 1948, the trustees filed a petition for approval of the sale of the "physical assets" of the Fountain which recited in part that the Committee had offered to purchase the assets thereof for the sum of $1,500, that the sum of $4,455.09 held by the trustees in the trust fund account was to be released to the bankrupt estate free and clear of any and all claims, but that "the balance" of the litigation involving Peggy Lou and her husband was not to be affected by the sale. On July 22, 1948, the Referee in Bankruptcy entered an order authorizing and directing the trustees "to deliver an executed Bill of Sale on * * * Your Food Fountain, * * * said Bill of Sale to cover all right, title and interest of the within estate in and to the items set forth in Exhibit 'A' and 'B' attached to the aforesaid petition." (R. 130; Pet. Ex. 10.) (The exhibits referred to are not part of Petitioners' Exhibit 10.)

[5] According to the testimony, Peggy Lou and her husband purchased property at San Bernardino, California, and with "fixtures" acquired from a former business established Your Food

part of her fiscal year extending from October 1947 to January 1948,[6] but that from January to June 1948 the restaurant was run as "private business" (not as a Church project) by a partnership of which she was a member.[7]

The Tax Court concluded that during the period from October 1947 to January 1948 Peggy Lou turned over the gross receipts of the business to the Committee "as a gift" (R. 85, 89, 144-145) and that "in the same manner" she turned over her share ($1,390.86) of the proceeds of the business in the January-June (partnership) period. In arriving at this conclusion, the Tax Court said (R. 89-90) that from the evidence it was clear that during the "October to July period" Peggy Lou "operated the restaurant under the agreement with the trustees in bankruptcy and the income she received from its operation was here and not the Committee's"; that the income was earned principally as a result of her efforts in operating the restaurant; that according to the agreement with the trustees she had an unqualified right to receive the funds from its operation; and that she actually did receive them. In support of its con-

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Fountain as a student minister training project. (R. 115-116, 144.) The number in the group was between 12 and 17. (R. 146.)

[6] Mrs. Huff, secretary to the Elected Delegates Committee, who was also a member of that Committee and a student minister of the Church, testified that the restaurant Your Food Fountain was operated as a student minister training project of the Church and that the proceeds (gross receipts) from that activity were "released" by taxpayer Riker "as the operator of that activity," to the Committee "up to January of 1948." (R. 102, 114-117.) Peggy Lou testified to the same effect. (R. 144-145.)

[7] See testimony at pages 149-150 of the record.

clusion, the Tax Court cited *Helvering* v. *Horst,* 311 U.S. 112, to the effect that income is taxable to the one who earns it or otherwise creates the right to receive it and enjoy the benefit of it when paid, and pointed out (R. 90) that the fact that her enjoyment of the income consisted of donating it to the Committee could not relieve her of the liability for tax on its receipt.

With respect to the income received during the third phase of the operation of the business, namely, from July to September 1948, the Tax Court held (R. 90) that Peggy Lou had failed to sustain her burden of overcoming the presumptive correctness of the Commissioner's determination that the amount (unknown) of income received was hers. As a matter of fact, and apart from the presumption, Peggy Lou's own testimony (R. 151) was that during this third phase she conducted the business "on a percentage basis" with a prospective buyer and turned over her share of the money from that operation to the Committee, thus establishing, as the Tax Court previously concluded (R. 89), that she had made a gift thereof to the Committee. Although the Tax Court seemed to think (R. 90) that "evidence" that the Committee owned the restaurant "equipment" during this period and that the proceeds from the "sale of the restaurant" late in 1948 or early in 1949 went to the Committee (R. 130)[8] tended "to meet this burden,"

[8] Mrs. Huff testified (R. 130) that when Your Food Fountain was eventually sold in 1949, the "main treasury of the church, the Elected Delegates Committee accountability," not Mrs. Riker, received the proceeds.

we submit, as previously pointed out, that ownership of the "equipment" is irrelevant to a determination of who had a right to the restaurant income, and that the evidence as to whether the Committee purchased the business or only its physical assets in July 1948, and ultimately sold the business or the assets, is so vague and confusing, that it cannot possibly serve "to meet" the burden of proof or establish that the income belonged to the Committee rather than Peggy Lou.

Taxpayers insist, however, that the "organization," apparently referring to the Committee (Br. 51, 58), is exempt under the provisions of Section 101(18) of the Code. Although they do not expressly say so, taxpayers' apparent purpose in advancing this contention is to establish that they had no individual taxable income other than that allegedly received during the taxable years as their pro rata share of the net income of the Committee. No reasons which are even remotely convincing have been offered in support of this contention. As demonstrated above, and found by the Tax Court, the income from the operation of the restaurant belonged to taxpayer Peggy Lou Riker and was taxable to her. Patently, the salary received by taxpayer Grassmee from private employment was also her income and not that of the Committee or the Church.

Section 101(18) was apparently designed to apply only to organizations whose members lived a communal religious life. It provides for the exemption from taxation of "Religious or apostolic associations or

corporations'' if (1) such associations or corporations have a common or community treasury, and (2) even though they engage in business for the ''common benefit'' of their members, but (3) only if the members include (at the time of filing their returns) in their gross income their pro rata shares, whether distributed or not, of the net income of the association or corporation for such year. Any amount so included in the gross income of a member is to be treated as a dividend received.

Although the application of Section 101(18) was raised in the case of *Johnson* v. *Commissioner,* decided January 17, 1952 (1952 P-H T.C. Memorandum Decisions, par. 52,007), appeal dismissed April 7, 1952 (C.A. 9th), it was not passed upon by the Tax Court. There appear to be no other reported decisions dealing with the section. However, the hearings before the Senate Finance Committee pertaining to the Revenue Act of 1936, c. 690, 49 Stat. 1648 (Hearings before the Committee on Finance on H. R. 12395, Part 11, May 28 and 29, 1936, 74th Cong., 2d Sess.), shed some light upon its purpose and intended application. During those hearings (which appear to constitute the only legislative history pertaining to Section 101(18)), reference was made to (p. 46) ''apostolic organizations who have a community interest,'' such as the House of David, the Shakers, and the Holy Rollers, whose members upon entering such organizations ''put in all of their property * * * and do a community business, run community farms, and all of the revenue is put in one pot and they are taxed

as a corporation.'"[9] We submit that it is clear from the Tax Court's findings and our discussion under Point II, *infra,* that the sole purpose of the Committee was to conduct the temporal affairs of the Church and that these affairs consisted principally of various commercial enterprises, and, therefore, that it was neither a religious or apostolic organization, nor did its members live the type of communal religious life contemplated by Section 101(18), so as to entitle them to the tax benefits accorded by that section.

II

THE CONTRIBUTIONS BY TAXPAYERS TO THE CHURCH, OR ITS PRINCIPAL TEMPORAL AGENCY, THE ELECTED DELEGATES COMMITTEE, ARE NOT DEDUCTIBLE UNDER SECTION 23(o)(2) OF THE INTERNAL REVENUE CODE OF 1939

Having determined that the income from the operation of the restaurant was taxable to Peggy Lou, there remains for consideration the question of whether she was entitled to deduct any part (15 per cent of her adjusted gross income) of the amount which she contributed to the Committee as a charitable contribution under Code Section 23(o)(2).[10] Although the Tax Court assumed a distinction between the Committee, the so-called "principal temporal agency" (R. 83) of the Church, and the "ecclesiastical society"

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[9] The purpose of the amendment appears to have been to afford some tax relief to persons, whether single or married, living a communal religious life, and who, because of the pooling of their earnings in an association taxed as a corporation, were unable to claim any personal or dependency exemptions.

[10] These same considerations also determine the deductibility of the contributions made by taxpayer Grassmee.

(R. 94) of the Church, we submit that no such distinction is warranted.

The Church itself was the organization which was incorporated as a religious body. (R. 81.) The fact that within itself it chose (according to its constitution and canon laws) to segregate its so-called "ecclesiastical" affairs from its temporal activities does not serve to create two separate and distinct entities insofar as its status as an exempt or non-exempt organization for tax purposes is concerned. As a matter of fact, even within the organization of the Church itself, any such distinction is without substance. The "ecclesiastical" functions of the Church were under the control of a "Senior Elder," and "Advisory Board of Elders," and a "College of Pastors." (R. 23-26.) No one could become a member of the Board unless confirmed by the Senior Elder (R. 24); the Board could only act subject to the written consent of the Senior Elder (R. 24-25); and the College of Pastors had only such powers as prescribed in writing by the Senior Elder (R. 26). The "temporal agencies" of the Church (of which the Committee was the principal one) were in turn "under and subject to the control of the ecclesiastical authorities" (R. 26), and were to operate only under charters granted by the Senior Elder with the advice of the Advisory Board (R. 25-26). At most, the constitution and canon laws of the Church specified only that "Insofar as practical" the ecclesiastical and temporal affairs of the Church should be kept separate. (R. 26, 33.) Obviously, then, the ecclesiastical and temporal agencies of the Church

were merely functional aspects thereof, and they in turn were under the complete dominion and control of the Senior Elder. To determine the question of deductibility, we address ourselves, therefore, to a consideration of whether the organization incorporated as "Christ's Church of The Golden Rule"[11] qualified as a religious organization so as to render contributions or gifts to it deductible under the provisions of Section 23(o)(2).

Insofar as pertinent here, Section 23(o)(2) provides three general conditions for deductibility. Two of the conditions are found in the requirement that the corporation be "organized and operated exclusively for religious * * * purposes"; the third is that "no part of * * * [its] net earnings * * * inures to the benefit of any private shareholder or individual." The Church does not fulfill any of these requirements or conditions.

As is apparent from its constitution, canon laws, and activities, the Church was not "organized and operated exclusively for religious" purposes. In fact, it appears therefrom that a substantial, if not the primary and fundamental, purpose of the Church was to operate commercial enterprises. To that end, the constitution and canon laws provided for the establishment and operation of so-called "temporal agencies"[12] of the Church. (R. 26-28, 33-40.) Such agencies were to hold their property in trust for the

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[11] The evidence does not support the Tax Court's finding (R. 81) that this Church "is" a religious nonprofit corporation. It was merely incorporated as such.

[12] See fn. 2, *supra*.

benefit of the "ecclesiastical organization" (R. 27-28, 33); they were to operate under charters granted by the Senior Elder with the advice of the Advisory Board (R. 26-27, 34); the income from the operations of any such agency or project was to belong to the "ecclesiastical" society of the Church and used for carrying on its "work" and "purposes" (R. 28, 37-40). The ostensible purpose of the Church appears to have been to promote a so-called "economic equality" (R. 22, 31-32) by having its members divest themselves of all private rights of ownership of property in favor of the Church, and thus "particularly to promulgate * * * the economic teachings of Christ Jesus" (R. 31). Exactly what "teachings" were referred to and how they were given "practical application" (R. 32) through the operation of the various projects is not explained.

In operation, as the Tax Court pointed out (R. 95), the record discloses "little evidence of activities of a purely spiritual nature, as commonly understood, being carried on by the Church." The Church had no church buildings, and apparently engaged in no formal religious exercises, but rather professed, *inter alia* (R. 32)—

> to teach and promote the spiritual, moral and financial welfare of all mankind by the practical application of Christianity; * * * to teach and exemplify the use of money or credit in any and all of its economic functions, and generally to teach and exemplify worthy and righteous business methods and scientific ways of procedure based upon Christ Jesus' "Golden Rule" of

absolute and impartial universal economic equality.

These announced purposes were allegedly carried on in part by "Student Minister Training Projects," most of which were engaged in commercial activities (R. 83, 95), such as the one operated by taxpayer Riker. As the Tax Court found (R. 83), the Committee, which operated these projects, carried on various commercial activities in competition with privately owned enterprises, including, among others, a restaurant, a laundry, a lumber yard, bulb gardens, farming, stock raising, and a warehouse. These enterprises were operated for profit, and the gross receipts were sent to the Committee covered by a form stating that the transfer was an outright gift from the project manager and was to be used only for Church purposes. (R. 83.) As the Tax Court said (R. 95), the very means chosen by the Church to attain its "spiritual purpose" involved engaging in commercial activities through its principal temporal agency, the Committee.

It is apparent, therefore, that the Church was neither organized nor operated exclusively for religious purposes, and that, as the Tax Court held (R. 93, 95), taxpayer Riker is not entitled to any deduction under Section 23(o) for the contributions turned over to the Church Committee.

Even if we assume, *arguendo,* as did the Tax Court (R. 92-93), that the ecclesiastical society of the Church, as distinguished from the Committee, qualified as a religious organization under Section 23(o), tax-

payers are still not entitled to any deduction. In so holding, the Tax Court referred to its decisions construing Section 101(6)[13] of the Code to the effect that, even though an organization is organized and operated to produce income for a tax exempt body, that fact does not render the producing entity (here, the Committee) exempt from taxation. At the same time, it recognized that some appellate courts had disagreed with its decisions in this respect. See, for example, *Roche's Beach, Inc.* v. *Commissioner,* 96 F. 2d 776 (C.A. 2d), reversing 35 B.T.A. 1087; and *C. F. Mueller Co.* v. *Commissioner,* 190 F. 2d 120 (C.A. 3d), reversing 14 T.C. 922. However, this Court has refused to apply this so-called "ultimate destination" test in several cases. See *John Danz Charitable Tr.* v. *Commissioner,* 231 F. 2d 673 (certiorari denied, October 8, 1956); *Ralph H. Eaton Foundation* v. *Commissioner,* 219 F. 2d 527; *Bear Gulch Water Co.* v. *Commissioner,* 116 F. 2d 975, certiorari denied, 314 U.S. 652; cf. *Squire* v. *Students Book Corp.,* 191 F. 2d 1018. And see *United States* v. *Community Services,* 189 F. 2d 421 (C.A. 4th), certiorari denied, 342 U.S. 932, where the ultimate destination test was rejected by the Fourth Circuit. As was the *Danz* case, so is this case, insofar as it relates to this point, controlled by this Court's decision in the *Ralph H. Eaton Foundation*

[13] Sections 101(6) and 23(o)(2) of the Internal Revenue Code of 1939 are similarly worded in their descriptions of organizations which are exempt and to which contributions may be deducted, so that it would appear that, if an organization is not entitled to tax exemption under Section 101(6), taxpayers making contributions to it would not be permitted to deduct those amounts under Section 23(o)(2).

case. As in the latter case, so here, as has been pointed out, the record and the findings of the Tax Court show that the Committee was actively and exclusively engaged in various commercial or business enterprises (R. 83, 95), and clearly was not intended to and did not operate as a religious organization. Furthermore, even if it be assumed, as was done in the *Eaton* case, that the function of the Committee in turning over the proceeds or contributions was an activity or operation, it certainly was not the exclusive one as required by the statute. Under the circumstances, then, no useful purpose would be served in any lengthy analysis of the decisions of other courts, cited by taxpayer (Br. 34-42), allegedly applying this test.

The Tax Court did not consider the third requirement of Section 23(o), namely, that no part of the net earnings of the Church inure to the benefit of any private individual, apparently on the theory that it was not necessary since the first two conditions had not been met. It is obvious, however, that taxpayer must also fail in her contention because of failure to prove this third condition. While, on the one hand, it is not possible to determine the "net earnings" of the Church and whether any part inured to the benefit of a private individual since its books and records were not produced in evidence; on the other hand, taxpayer stated in her 1948 return (R. 86-87) that in 1948 she and her daughter each received a 1/575 interest, or $377.39 each, in $217,001.54 "net income" of the Committee. Similarly, the Committee's returns as an "apostolic society" showed the undistributed

pro rata share of each member thereof to be $342.27 for 1948 and $316.17 for 1949. (R. 84.) In addition, the "Church Government" established a budget on which each local group or project levied which averaged between $17 and $20 per individual per month and "covered all living expenses."[14] These sums were made available through "revolving funds"—one to meet the operating expenses of each project, the other to meet the living expenses of the particular group. The funds for the "revolving funds" in turn appear to have come from the gross receipts from the operation of the various projects which were turned over to the Committee. (R. 117-119, 122-123, 125, 137, 147-148.) Insofar as appears from the record then, the members of the Church did share in the net earnings of the Church, and for this reason also it cannot be said to qualify as a religious organization, contributions to which are deductible under Section 23(o)(2).

It is no argument to say, as taxpayers do (Br. 23-29), that Section 101(6) must be given a liberal interpretation. It is a familiar rule of construction that deductions are a matter of legislative grace, not of right. *Deputy* v. *duPont,* 308 U.S. 488, 493; *New Colonial Co.* v. *Helvering,* 292 U.S. 435, 440. In any event, general rules of construction, while sometimes helpful in resolving ambiguities, cannot serve to defeat the plainly expressed legislative intent even where religious or charitable organizations are involved. *United States* v. *Community Services, supra;*

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[14] During the years 1948 and 1949, there was a cash fund for petty purchases in the amount of $5 per individual per month. (R. 135.)

Universal Oil Products Co. v. *Campbell,* 181 F. 2d 451 (C.A. 7th), certiorari denied, 340 U.S. 850; *Scholarship Endowment Foundation* v. *Nicholas,* 106 F. 2d 552 (C.A. 10th), certiorari denied, 308 U.S. 623. As the Supreme Court said in *Better Business Bureau* v. *United States,* 326 U.S. 279, 283:

> Even the most liberal of constructions does not mean that statutory words and phrases are to be given unusual or tortured meanings unjustified by legislative intent or that express limitations on such an exemption are to be ignored.

III

TAXPAYER GRASSMEE WAS NOT ENTITLED TO A DEPENDENCY CREDIT FOR HER MOTHER FOR THE YEARS 1948 AND 1949

As appears from the Tax Court's finding (R. 87), taxpayer Grassmee claimed a dependency credit for her mother on her 1948 and 1949 income tax returns. In an amended answer to her complaint, however, the Commissioner claimed increased deficiencies based on disallowance of the dependency credits claimed. (R. 80, 88.)

Although taxpayer has not briefed this point as a separate issue, it was raised as one of her points on appeal. (R. 161.) This dependency claim is mentioned by taxpayer, however, in connection with the contention that the Committee was an exempt organization under Section 101(18) (Br. 50, 53, 57), apparently on the theory, as the Tax Court thought (R. 87, 96), that part of the earnings taxpayer Grassmee turned over to the Committee was for the support of her mother

who lived with her in a Church residential project and participated in religious activities of the Church.

In sustaining the Commissioner's claims for increased deficiencies, the Tax Court pointed out that there was no evidence that the support received by the mother was conditioned on the making of a contribution or the payment of money by her daughter. It concluded, therefore, that taxpayer Grassmee did not furnish over half of the support for her mother during the years in question, and, hence, was not entitled to any dependency credit under Section 25(b)(1)(D) and (3) of the Internal Revenue Code of 1939, Appendix, *infra*. See *Tressler* v. *Commissioner*, 206 F. 2d 538 (C.A. 4th).

CONCLUSION

The decision of the Tax Court is correct and should be affirmed.

Respectfully submitted,

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APPENDIX

Internal Revenue Code of 1939:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(o) *Charitable and Other Contributions.* — In the case of an individual, contributions or gifts payment of which is made within the taxable year to or for the use of:

* * * * *

(2) [as amended by Section 224(a) of the Revenue Act of 1939, c. 247, 53 Stat. 862] A corporation, trust, or community chest, fund, or foundation, created or organized in the United States or in any possession thereof or under the law of the United States or of any State or Territory or of any possession of the United States, organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, and no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation;

* * * * *

(26 U.S.C. 1952 ed., Sec. 23.)

SEC. 25. CREDITS OF INDIVIDUAL AGAINST NET INCOME.

* * * * *

(b) [as amended by Section 10(b) of the Individual Income Tax Act of 1944, c. 210, 58 Stat. 231; Section 102(a) of the Revenue Act of 1945, c. 453, 59 Stat. 556; and Section 201 of the Revenue Act of 1948, c. 168, 62 Stat. 110] *Credits for Both Normal Tax and Surtax.*—

(1) *Credits.*—There shall be allowed for the purposes of both the normal tax and surtax, the following credits against net income:

* * * * *

(D) An exemption of $600 for each dependent whose gross income for the calendar year in which the taxable year of the taxpayer begins is less than $500, * * *

* * * * *

(3) *Definition of Dependent.*—As used in this chapter the term "dependent" means any of the following persons over half of whose support, for the calendar year in which the taxable year of the taxpayer begins, was received from the taxpayer:

* * * * *

(26 U.S.C. 1952 ed., Sec. 25.)

SEC. 101. EXEMPTIONS FROM TAX ON CORPORATIONS.

The following organizations shall be exempt from taxation under this chapter:

* * * * *

(6) Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, and no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation;

* * * * *

(18) Religious or apostolic associations or corporations, if such associations or corporations have a common treasury or community treasury, even if such associations or corporations engage in business for the common benefit of the members, but only if the members thereof include (at the time of filing their returns) in their gross income their entire pro-rata shares, whether distributed or not, of the net income of the association or corporation for such year. Any amount so included in the gross income of a member shall be treated as a dividend received.

(26 U.S.C. 1952 ed., Sec. 101.)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

Sec. 29.25-3 [as amended by T.D. 5517, 1946-2 Cum. Bull. 8, and T.D. 5687, 1949-1 Cum. Bull. 9]. *Personal exemption, surtax exemptions, and exemptions for both normal tax and surtax.*—

* * * * *

(d) *Taxable years beginning after December 31, 1947.*— * * *

* * * * *

(5) *Exemptions for dependents.*—Section 25(b)(1)(D) allows to a taxpayer an exemption of $600 for each dependent whose gross income for the calendar year in which the taxable year of the taxpayer begins is less than $500, who receives more than one-half of his support from the taxpayer for such calendar year and who does not file a joint return with his spouse. * * *

* * * * *

Sec. 29.101(6)-1. *Religious, Charitable, Scientific, Literary, and Educational Organizations and Community Chests.*—In order to be exempt under section 101(6), the organization must meet three tests:

(1) It must be organized and operated exclusively for one or more of the specified purposes;

(2) Its net income must not inure in whole or in part to the benefit of private shareholders or individuals; and

(3) It must not by any substantial part of its activities attempt to influence legislation by propaganda or otherwise.

* * * * *

Since a corporation to be exempt under section 101(6) must be organized and operated exclusively for one or more of the specified purposes, an organization which has certain religious purposes and which also manufactures and sells articles to

the public for profit, is not exempt under section 101(6) even though its property is held in common and its profits do not inure to the benefit of individual members of the organization. * * *

* * * * *

Sec. 29.101(18)-1 [as amended by T.D. 5458, 1945 Cum. Bull. 45, and T.D. 5600, 1948-1 Cum. Bull. 5]. *Religious or Apostolic Associations or Corporations.*—Religious or apostolic associations or corporations are exempt from taxation under chapter 1 if they have a common treasury or community treasury, even though they engage in business for the common benefit of the members, provided each of the members includes (at the time of filing his return) in his gross income his entire pro rata share, whether distributed or not, of the net income of the association or corporation for the taxable year of the association or corporation ending with or during his taxable year. Any amount so included in the gross income of a member shall be treated as a dividend received.

Every association or corporation claiming exemption as a religious or apostolic association or corporation under the provisions of section 101(18) and this section shall make for each taxable year a return on Form 1065 * * * stating specifically the items of its gross income and deductions, and its net income, and there shall be attached to the return as a part thereof a statement showing the name and address of each member of the association or corporation and the amount of his distributive share of the net income of the association or corporation for such year. If the taxable year of any member is different from the taxable year of the association or cor-

poration, the distributive share of the net income of the association or corporation to be included in the gross income of the member for his taxable year shall be based upon the net income of the association or corporation for the taxable year of the association or corporation ending within the taxable year of the member.

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